

Message Text

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DEPARTMENT PASS TREASURY AND FRB

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TAGS: ECIN, ECON, ECRP, IT

SUBJECT: STATE OF THE ECONOMY, OPTIONS FOR THE FUTURE

SUMMARY. AFTER NEGATIVE GROWTH IN GDP OF ABOUT 3.5 PERCENT IN 1975 THERE IS FAIRLY GOOD EVIDENCE THAT ITALY'S RECESSION REACHED ITS TROUGH AROUND AUGUST 1975 AND IS ALREADY ON A SLOW UPWARD GROWTH PATH. UNFORTUNATELY, THERE IS ALSO EVIDENCE THAT PRICE RISES AND BALANCE OF PAYMENTS PROBLEMS ARE ALREADY RE-EMERGING, PARTLY AS RESULT OF ECONOMIC RECOVERY BUT ALSO BECAUSE OF UNSTABLE POLITICAL SITUATION, CONTINUED COST PUSH INFLATION AND MASSIVE BUDGET DEFICITS. EXCEPT FOR USE OF MONETARY POLICY (WITHIN LIMITS PERMITTED BY NEED TO FINANCE CASH BUDGET DEFICIT) FEW CHANGES CAN BE EXPECTED IN 1976 IN ECONOMIC POLICIES BY PRESENT WEAK GOVERNMENT. END SUMMARY.

1. PRODUCTION. GDP DURING FIRST NINE MONTHS OF 1975 DECLINED IN REAL TERMS BY 4.9 PERCENT FROM SAME PERIOD OF 1974. EM-BASSY UNDERSTANDS THAT DECLINE FOR YEAR WAS A LITTLE LESS
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THAN 3.5 PERCENT, INDICATING SLIGHT UPTURN IN LAST QUARTER.

INDUSTRIAL PRODUCTION DURING 1975 DROPPED IN REAL TERMS BY 9.5 PERCENT BUT SHOWED AN IMPROVEMENT IN THE LAST QUARTER SUGGESTING THAT THE RECESSION HAD BOTTOMED IN THE PREVIOUS QUARTER. FOR 1976 MOST FORECASTS ARE FOR 1-2 PERCENT IN REAL GROWTH OF GDP. IN EMBASSY'S OPINION THESE FIGURES MAY BE TOO LOW, GIVEN VERY LOW BASE FROM WHICH RECOVERY STARTS. HOWEVER, BALANCE OF PAYMENTS CONSTRAINT CANNOT BE OVERLOOKED AND RESPONSE OF EXPORTS TO RECENT DEPRECIATION OF LIRA WILL BE CRITICAL FACTOR IN DETERMINING RATE OF GROWTH WHICH IS COMPATIBLE WITH LIMITED FOREIGN CREDIT AVAILABLE TO ITALY FOR MEETING BALANCE OF PAYMENTS DEFICIT.

2. DOMESTIC DEMAND. DOMESTIC DEMAND DURING 1975 REMAINED LOW THROUGHOUT THE YEAR. DURING FIRST 9 MONTHS OF 1975 PRIVATE CONSUMPTION, PUBLIC CONSUMPTION AND INVENTORY ACCUMULATION COMBINED DECLINED BY 8.0 PERCENT COMPARED TO SAME PERIOD OF 1974. (ALTHOUGH THESE COMPONENTS OF DEMAND ARE NOT AVAILABLE SEPARATELY, BULK OF DECLINE WAS IN PRIVATE CONSUMPTION AND INVENTORY LIQUIDATION.) LARGE DECREASE IN IMPORTS BOTH IN VOLUME (11.4 PERCENT) AND IN VALUE (6.1 PERCENT) ARE INDICATIVE OF THIS LOW DEMAND. WHILE DEMAND FOR OIL WAS DOWN IN 1975 COMPARED TO 1974, IT SHOULD BE BORNE IN MIND THAT PART OF THIS REDUCTION IN DEMAND IS RESULT OF REDUCED INDUSTRIAL PRODUCTION. ONE CAN EXPECT, THEREFORE, THAT WITH RISING INDUSTRIAL PRODUCTION, DEMAND FOR OIL AND FOR OTHER INDUSTRIAL RAW MATERIALS WILL INCREASE IN PARALLEL FASHION. ANOTHER RESULT OF LOW DOMESTIC DEMAND WAS RATHER REMARKABLE PERFORMANCE OF EXPORTS IN FACE OF GENERAL WORLDWIDE DECLINE IN TRADE. ITALY, IN FACT, ACTUALLY MANAGED TO INCREASE ITS MARKET SHARE OF GLOBAL EXPORT MARKET DURING 1975. WORLD TRADE FELL BY 6-7 PERCENT IN VOLUME TERMS DURING 1975, WHEREAS ITALY'S EXPORTS INCREASED BY 2.3 PERCENT.

3. INFLATION. ITALY'S COST OF LIVING IN 1975 ROSE BY MORE THAN 17 PERCENT ON AVERAGE OVER 1974. HOWEVER, BETTER MEASURE OF RATE OF CHANGE WAS 11 PERCENT RISE DECEMBER 75/DECEMBER 74, COMPARED TO 25 PERCENT RISE DECEMBER 74/DECEMBER 73. DESPITE IMPROVEMENT, RECENT DATA ARE SOMEWHAT WORRISOME, PARTICULARLY 1.4 PERCENT AND 1.7 PERCENT MONTHLY INCREASES IN WHOLESALE INDEX IN DECEMBER AND JANUARY (COMPARED LIMITED OFFICIAL USE

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TO AVERAGE MONTHLY INCREASE THROUGHOUT 1975 OF ONLY 0.4 PERCENT). IN CONTRAST WITH 1973-74 THERE WAS NO DEMAND PUSH NOR COMMODITY BOOM CAUSES OF INFLATION DURING 1975. DURING THE YEAR, ITALIAN MONETARY POLICY HELD TO A COURSE OF GRADUAL RELAXATION OF CREDIT STRICTURES WHICH HAD BEGUN IN FIRST HALF AND THROUGHOUT MOST OF 1975 THIS POLICY SEEMED CONSISTENT WITH HOLDING DOWN RATE OF PRICE INCREASES. IT THUS APPEARS THAT INSISTENTLY RISING LABOR COSTS WHICH PERSISTED

RIGHT THROUGH ECONOMIC RECESSION (AVERAGING 30 PERCENT ACROSS THE BOARD WITH A 32.7 PERCENT INCREASE IN AGRICULTURAL SECTOR, 28 PERCENT IN INDUSTRY AND 30.7 PERCENT IN COMMERCIAL ACTIVITIES) AND RAPID RISE IN LIQUIDITY LATE IN YEAR (PARTLY DUE TO FINANCING OF CASH BUDGET) WERE MAJOR CAUSES OF PRICE RISES.

4. EMPLOYMENT. AVERAGE UNEMPLOYMENT STATISTIC FOR 1975 WAS 3.3 PERCENT (654,000) AS PUBLISHED BY ISTAT ON THE BASIS OF QUARTERLY SURVEYS. (IT IS MAINTAINED BY LABOR UNIONS THAT ACTUAL UNEMPLOYMENT MIGHT WELL HAVE BEEN AS HIGH AS 1.2 MILLION ALTHOUGH THERE IS NO REASON TO QUESTION OFFICIAL DATA WHICH IS COMPILED ON BASIS INTERNATIONALLY AGREED STANDARDS.) ISTAT FIGURES ALSO INDICATE THAT THE UNDEREMPLOYED WERE 2.3 PERCENT OF THE WORK FORCE DURING COURSE OF YEAR. WHILE BOTH FIGURES ARE UP CONSIDERABLY COMPARED TO UNEMPLOYMENT AND UNDEREMPLOYMENT IN 1974 (2.9 AND 1.6 PERCENT RESPECTIVELY), CONSIDERING THE EXTENT OF THE REDUCED INDUSTRIAL ACTIVITIES THESE FIGURES CANNOT BE CONSIDERED EXCESSIVELY HIGH.

5. MONETARY AND FISCAL MEASURES. A STEP BY STEP REDUCTION IN COST OF MONEY DURING 1975, GUIDED BY LOWERING CENTRAL BANK DISCOUNT RATES THREE TIMES, AND OTHER MEASURES TO RELAX CREDIT CONTROLS, DID NOT STIMULATE SIGNIFICANT INCREASE IN DEMAND FOR INVESTMENT. SAVINGS DID INDEED INCREASE, HOWEVER, THUS ALLOWING FOR CONSIDERABLE LIQUIDITY TO BUILD UP IN BANKING SYSTEM. AT SAME TIME, GOVERNMENT'S ATTEMPT TO INCREASE ITS SPENDING ON GOODS AND SERVICES TO SPUR DEMAND BY MEANS OF ANTI-RECESSION PACKAGE IN AUGUST (WHICH LARGELY CONSISTS OF FACILITATIVE LOANS), HAD VIRTUALLY NO IMPACT IN 1975. ALTHOUGH 4,000 BILLION LIRE WERE AUTHORIZED IN THAT PACKAGE FOR EXPENDITURES OVER THREE-YEAR PERIOD, ALMOST NO FUNDS WERE OBLIGATED AGAINST THAT AUTHORIZATION.

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6. BALANCE OF PAYMENTS. ASTOUNDING TURN-AROUND IN BALANCE OF PAYMENTS SITUATION IN 1975 COMPARED TO 1974 WAS MOSTLY RESULT OF: A) REDUCED OIL DEMAND, B) REDUCED DEMAND FOR OTHER IMPORTS, AND C) DIVERSION OF PRODUCTION TO EXPORT MARKETS IN FACE OF LOW OVERALL DOMESTIC DEMAND. ECONOMIC RECOVERY IN 1976 WILL, HOWEVER, REQUIRE AN INCREASE IN IMPORTS AS INVENTORIES ARE RESTOCKED AND PRODUCTION INCREASES. INITIAL SCENARIO FORESEEN FOR ITALY'S 1976 BALANCE OF PAYMENTS WAS FOR GRADUAL WEAKENING IN CURRENT ACCOUNT AS RECOVERY ACCELERATED LATE IN YEAR AND WORSENING OF CAPITAL ACCOUNT AS SPRING 1977 ELECTIONS APPROACHED. FALL OF GOVERNMENT IN JANUARY AND DEPRECIATION OF LIRA FOLLOWING WITHDRAWAL OF BANK OF ITALY FROM MARKET THAT MONTH HAVE CHANGED THESE PROSPECTS. POLITICAL UNCERTAINTIES, FEAR OF FURTHER LIRA DEPRECIATION, CONCERN ABOUT INCREASING COMMODITY PRICES AND EVIDENCE OF RECOVERY OF INDUSTRIAL PRODUCTION HAVE PROBABLY ALREADY GIVEN RISE TO SPECULATION IN INVENTORIES IN REAL TERMS AND TO SPECULATION IN PAYMENTS TERMS THROUGH ADVANCE IMPORT PAYMENTS, DELAYED EXPORT RECEIPTS (WITHIN LEGAL LIMITS), UNDER AND OVER-INVOICING AND LIMITED OFFICIAL USE

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OTHER FORMS OF CAPITAL FLIGHT. RESULT MAY BE THAT WORSENING OF CURRENT ACCOUNT WILL OCCUR SOONER THAN PREVIOUSLY EXPECTED. IN ADDITION "J-CURVE" EFFECT OF IMMEDIATE WORSENING IN ITALY'S TERMS OF TRADE FROM LIRA DEPRECIATION WILL OCCUR IN FIRST HALF 1976. SIMILARLY, IN CAPITAL ACCOUNT, FLIGHT OF CAPITAL HAS ALREADY SHOWN UP EARLY THIS YEAR AND UNCERTAIN FUTURE OF GOVERNMENT PROVIDES FERTILE GROUND FOR FURTHER OUTFLOWS. NET RESULT OF THESE FACTORS IS THAT BALANCE OF PAYMENTS IN FIRST HALF OF THIS YEAR MAY BE MUCH WORSE THAN PREVIOUSLY EXPECTED.

CONVERSELY, SECOND HALF OF YEAR COULD PROVE TO BE RELATIVELY BETTER, SINCE ADVERSE LEADS AND LAGS COULD TURN AROUND AND POSITIVE EFFECTS OF DEPRECIATION OF LIRA ON EXPORTS SHOULD BEGIN TO BE FELT.

7. EXCHANGE RATE. IT IS INCORRECT TO INTERPRET THE BANK OF ITALY'S (BOI) SUDDEN WITHDRAWAL FROM EXCHANGE MARKET IN JANUARY AS INDICATION OF EQUALLY SUDDEN CRISIS OF LIRA. FROM A STRICTLY ECONOMIC POINT OF VIEW, IT WAS PROBABLY MISTAKEN POLICY FOR BOI TO STABILIZE VALUE OF LIRA DURING SECOND HALF OF 1975 WITHIN VERY NARROW RANGE IN FACE OF CONTINUALLY HIGH COST AND PRICE INFLATION, ANTICIPATED RESURGENCE OF IMPORTS IN 1976 AND LARGE DEBT REPAYMENTS DUE IN 1976 AND BEYOND. MORE FORESIGHTED POLICY WOULD PROBABLY HAVE BEEN TO HAVE PERMITTED GRADUAL DEPRECIATION OF LIRA DURING SECOND HALF OF 1975.

8. CHOICES AHEAD. ASIDE FROM POLITICAL CONSIDERATIONS WHICH BEAR OVERWHELMINGLY ON GOVERNMENT'S ABILITY TO ACT, MAJOR CONSTRAINTS ON ITALIAN ECONOMIC POLICY ARE: A) CASH BUDGET DEFICIT, B) EXTERNAL DEBT, AND C) RISING UNIT LABOR COSTS. BANK OF ITALY OFFICIALS SEEM CONVINCED OF NEED TO LET LIRA FLOAT CLEANLY IN LINE WITH UNDERLYING ECONOMIC CONDITIONS. THERE WILL BE PRESSURES FROM LABOR UNIONS AND POLITICAL PARTIES ON MINISTRY OF THE TREASURY TO STABILIZE RATE IN ATTEMPT TO KEEP DOWN FEEDBACK EFFECT ON DOMESTIC PRICES AND DEMONSTRATE TO VOTERS GOI ABILITY TO DEAL WITH CRISIS. HOWEVER, OBVIOUS INADEQUACY OF BANK OF ITALY RESERVES WILL HELP BANK TO RESIST SUCH PRESSURE. ALSO, MONETARY POLICY CAN PROBABLY BE KEPT UNDER REASONABLY GOOD CONTROL, DESPITE PRESSURES TO AVOID "CREDIT CRUNCH". CASH BUDGET DEFICIT CAN ONLY BE REMEDIED BY GREATER CONTROL ON SPENDING AND INCREASING REVENUES THROUGH LIMITED OFFICIAL USE

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MORE EFFICIENT COLLECTION, BOTH OF WHICH WILL TAKE SOME TIME. TO THIS END, LIMITS BEING SET BY IMF AND EEC ON TOTAL BORROWING BY TREASURY AND ON TREASURY BORROWING FROM BOI SHOULD HELP GOVERNMENT TO BEGIN TO PUT ITS FINANCIAL HOUSE BACK IN ORDER.

9. BUT MORE FUNDAMENTAL PROBLEM OF DECREASING COMPETITIVENESS RESULTING FROM INCREASING UNIT LABOR COSTS IS MORE DIFFICULT TO SOLVE. OPPORTUNITY EXISTS NOW FOR ATTACK ON THIS PROBLEM, SINCE LARGE SCALE CONTRACT NEGOTIATIONS ARE UNDERWAY AND LABOR UNIONS HAVE BEEN CONSIDERABLY FRIGHTENED BY RECESSION AND FALL OF LIRA AND MAY BE MORE OPEN TO SOME SACRIFICES. HOWEVER, OPPORTUNITY WILL LIKELY BE LOST, SINCE IT IS DIFFICULT TO IMAGINE THAT PRESENT GOVERNMENT WILL BE ABLE TO IMPOSE INCOMES POLICY UNDER PRESENT POLITICAL CONDITIONS. IT MAY BE WORTH REMEMBERING THAT THE UK WAS ONLY BARELY ABLE TO BRING AN INCOMES POLICY INTO BEING IN FACE OF FAR SEVERER

SITUATION THAN ITALY FINDS ITSELF IN NOW, AND WITH A LABOR
GOVERNMENT IN POWER AT THAT.

10. IN SUM, 1976 WILL PROBABLY PROVE TO BE BETTER THAN 1975
AS TO GROWTH -- BUT NOT MUCH. EMPLOYMENT SITUATION COULD
WORSEN -- BUT NOT A LOT. BALANCE OF PAYMENTS DEFICIT FOR
WHOEL YEAR MAY BE FAIRLY SMALL AND FINANCIALLY TOLERABLE --
BECAUSE OF LIRA DEPRECIATION AND BECAUSE FOREIGNERS ARE STILL
WILLING TO PROVIDE SOME FINANCING. PRICES WILL AGAIN BE TOO
HIGH -- AND PROBABLY ACCELERATING AS YEAR PROGRESSES. GOI
ECONOMIC POLICIES WILL CONSIST OF ADEQUATE EXCHANGE RATE AND
MONETARY POLICIES -- BUT LITTLE ELSE. AND, EVERYONE (OR AT
LEAST MOST) WILL HOPE THAT NEW GOVERNMENT FOLLOWING NEXT
ELECTIONS WILL BE BOTH DEMOCRATIC AND WILLING TO EMBARK ON
MORE FUNDAMENTAL CORRECTIVE ECNOMIC POLICIES. VOLPE

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